Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-605

JERRY D. FRIDRICH, ET AL.

Petitioners,

v.

J.C. BRADFORD, ET AL.

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR RESPONDENTS IN OPPOSITION

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OPINIONS BELOW

The opinion delivered in the United States Court of Appeals for the Sixth Circuit is reported in [Current Volume] CCH Fed. Sec. L. Rep. at ¶95,723. The memorandum of the United States District Court for the Middle District of Tennessee is reported in ['74-'75 Transfer Binder] CCH Fed. Sec. L. Rep. at ¶94,723.

QUESTIONS PRESENTED

1. After being informed by an official of an insurance holding company that his corporation contemplated a merger offer to a life insurance company, defendants (other than J. C. Bradford & Co.) bought unlisted stock in the target company from broker-dealers selling as principals, but did not make a public announcement of the information received. Plaintiffs sold stock in the target company several weeks later. There was no contractual or other relationship between defendants and plaintiffs. Under Section 10(b) of the Securities and Exchange Act of 1934 (15 U.S. Code §78j) and Rule 10b-5 of the Securities and Exchange Commission, are defendants liable in damages to plaintiffs who sold stock of the target company six weeks after defendants' purchases but prior to the actual merger offer and its public announcement by the corporations involved?

2. Defendant, J. C. Bradford & Co., a broker-dealer, continued to make a market in the stock of the target company after two of its partners received the foregoing information. Was this defendant liable to plaintiffs under Rule 10b-6 of the Securities and Exchange Commission?

COUNTERSTATEMENT OF THE CASE

The statement of facts contained in Section I of the opinion below, reprinted at pages 3b-9b of the Appendix to the Petition,[1] is essentially correct, except that in the first full paragraph on page 5b, it is erroneously stated that Crosby, in effect, proposed to J. C. Bradford an acquisition of Old Line by USLIFE in April of 1972, and agreed to negotiate the acquisition only with Bradford. In fact, Crosby contacted Bradford at that time in order to get Bradford to propose the merger on

[1] All references to the opinion below will be by citation to pages of the Appendix to the Petition.

USLIFE's behalf to management of Old Line. Bradford at that time was neither an officer nor a director of Old Line, but had influence as a major stockholder and former director of Old Line. See Stipulations 13 through 17 reproduced at pages 25-28 of printed Appendix filed in the Court of Appeals.

The Statement of the Case in the Petition contains a number of inaccuracies in its recitation of facts. The only defendant who was a director of Old Line at any time relevant to the issues in this case was J. C. Bradford, Jr. The defendants did not control Old Line. During 1972, all of the defendants, together with members of the Bradford family and all partners and employees of Bradford & Co. owned, in the aggregate, no more than 17% of all shares of Old Line stock outstanding. J. C. Bradford himself owned approximately 5% of such stock. J. C. Bradford & Co., not J. C. Bradford, was a market maker for Old Line stock, and J. C. Bradford & Co., not J.C. Bradford, continued to make a market in Old Line stock throughout 1972. See Stipulations 7 through 11, at pages 23-24 of Appendix in Court of Appeals.

Contrary to the assertion at the bottom of page 8 of the Petition, the District Court did not find that defendants' asserted violation of Rule 10b-6 adversely affected the market. The Court of Appeals concluded, to the contrary, that there was no evidence of market manipulation (n. 13 and 15 at App. pages 10b-12b).

REASONS FOR DENYING THE WRIT

I. NO REAL CONFLICT AMONG THE CIRCUITS.

The principal ground urged by plaintiffs for grant of certiorari is a supposed conflict, on the first question presented, between the opinion below and the opinion of the Court of Appeals for the Second Circuit in *Shapiro* v. *Merrill Lynch,*

Pierce, Fenner & Smith, 495 F.2d 222 (2d Cir. 1974).[2] The factual distinctions between the two cases are so fundamental that any conflict is more apparent than real, and as Judge Celebreeze pointed out in his concurring opinion, the decision of the Sixth Circuit in the instant case could well have been based on other grounds, which would not even apparently conflict with the *Shapiro* v. *Merrill Lynch* opinion. Some of these factual distinctions and other grounds will now be pointed out:

A. Identity of persons on other side of transaction.

In the instant case, unlike *Shapiro* v. *Merrill Lynch,* the defendants knew the exact identity of the persons selling the stock defendants purchased. The purchase by J.C. Bradford for his wife was from stock owned by his own firm, J.C. Bradford & Co. The purchase by J.C. Bradford, Jr. for himself was likewise from stock owned by J.C. Bradford & Co. The purchases by Mr. Bradford for Life Stock Research Company were likewise from stock owned by J.C. Bradford & Co., with the exception of one purchase from another dealer, Bache & Co. See Stipulation 54 at page 51 of Appendix in Court of Appeals. Thus the defendants had the opportunity to disclose their information privately to the sellers without making a public announcement. Whether they did or did not do so might affect their liability to the sellers, but not to others. The decision reversing the District Court in this case might well have been placed on this ground without a discussion of the impersonal market problem. It is true that trades on the over-the-counter market may be

[2] While conflict with *Blackie* v. *Barrack,* 524 F.2d 891,906-908 (9th Cir. 1975) and *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corporation,* 426 F.2d 569 (1970), 480 F.2d 341 (1973), 516 F.2d 172 (1975) *cert. granted,* (April 5, 1976) (Nos. 75-353, 75-354, 75-355) is also claimed, the *Blackie* case involved a deception "inflating the price of stock traded in the open market," 524 F.2d 904, a circumstance which the Sixth Circuit specifically noted to be absent in this case (see Section I D at 7 *infra),* and *Chris-Craft* is distinguishable on similar grounds (see Section IV at 13 *infra*).

impersonal, as where the broker acts for an undisclosed principal; but in the instant case, the transactions were face to face and not impersonal.

As to plaintiffs' sales, they were made six weeks later to a known purchaser, A.G. Edwards and Sons & Co., Inc. and there was no connection between defendants' purchases and plaintiffs' sales. See Stipulation 59 at page 54 of Appendix filed in Court of Appeals.

B. Restitution.

In the instant case the defendants made (or offered) full restitution to all persons (including dealers) who sold Old Line stock to J.C. Bradford & Co. during the period when the other defendants were buying such stock from J.C. Bradford & Co., and also to all customers who sold Old Line stock to J.C. Bradford & Co., prior to the public announcement on June 29, 1972, made by Old Line Life Insurance Company to the effect that USLIFE had made a merger proposal (App. page 8b). The amount paid in restitution exceeded the profits of defendants (App. page 9b), realized or unrealized, so that, as pointed out by the Court of Appeals, the "impact" of the sanctions so imposed "is bound to be significant," whether or not considered to be "a sufficient vindication of the public rights and an adequate deterrent to future misconduct." (App. page 29b)

C. Confidentiality of the nonpublic information.

Plaintiffs in the instant case claim to have been damaged by defendants' breach of an asserted duty to make a public announcement of confidential information imparted to one of them by USLIFE concerning USLIFE's interest in acquiring Old Line. This duty to disclose, it is claimed, was imposed by Rule 10b-5, as applied by the Second Circuit Court of Appeals in *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833 (1968) and in *Shapiro* v. *Merrill Lynch.* Neither of these cases, however, holds that Rule 10b-5 requires an insider to breach a duty he

may have to maintain a corporate confidence. [3] In *Texas Gulf Sulphur*, which was the genesis of the so-called "abstain or disclose" rule, the Second Circuit specifically recognized that a duty to maintain a corporate confidence might foreclose any conflicting duty of public disclosure, in which case the insider's only duty is **not to trade:**

> "Thus, anyone in possession of material inside information must either disclose it to the investing public, **or, if he is disabled from disclosing it in order to protect a corporate confidence,** or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such information remains undisclosed." (Emphasis added.)
>
> 401 F.2d at 848

There is no suggestion that an illegal trade removes the duty **not** to disclose.

In *Shapiro* v. *Merrill Lynch*, it was alleged that Merrill Lynch received adverse confidential earnings information concerning Douglas Aircraft Company and disclosed it to the Selling Defendants, whose massive sales caused a sharp drop in the price of Douglas Aircraft stock. Such disclosure constituted a breach of duty of confidentiality to Douglas. [4] The complaint alleged that "the defendants" defrauded plaintiffs by "withholding from them the material inside information described in

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[3] Restatement (Second) of Agency §395 (1958) provides:
"Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency. . .unless the information is a matter of general knowledge."

[4] The Statement of Policy which Merrill Lynch was required to adopt pursuant to the order entered in the SEC Broker-Dealer proceedings growing out of its Rule 10b-5 violations was fashioned "to provide more effective protection against disclosure of confidential information." Securities Exchange Act Release No. 8459 (1968).

paragraph '28' once the Selling Defendants commenced selling Douglas stock on the basis of this material inside information" and then alleged:

> "37. Although Merrill Lynch and the individual defendants [officers and salesmen of Merrill Lynch] were obligated to keep confidential the material information set forth in paragraph "28" of this amended complaint, once the said information was disclosed to the Selling Defendants, **then the defendants** were obligated to disclose this information to the general investing public..."

In the instant case, on the other hand, the information concerning USLIFE's interest in acquiring Old Line continued to be confidential throughout the period of defendants' trades, and remained confidential at the time of plaintiff's sales, six weeks later. See Stipulation 26 at pages 30-31 of Appendix in Court of Appeals. Plaintiffs are, in effect, arguing that once defendants purchased Old Line shares, a duty was imposed on them to violate their duty of confidentiality to USLIFE. The Second Circuit did not address this question. If and when it is addressed, after an evidentiary hearing, the decision may be entirely consistent with that in the instant case.

D. No price change as a result of trades as there was in *Shapiro* v. *Merrill Lynch*.

In his opinion in the instant case, Judge Engel pointed out:

> "Defendants' trading did not alter plaintiffs' expectations, and in no way influenced plaintiffs' trading decision." (App. page 22b).

And in note 27 (App. page 26b), Judge Engel cautioned,

> "We specifically do not reach the question of the availability of the remedy to open market situations where the insider trading with the resultant price changes has in fact induced the plaintiffs to buy or sell to their injury."

In *Shapiro* v. *Merrill Lynch*, on the other hand, the Second Circuit recited that defendants' sales of 165,000 shares of Douglas common during the period June 20 through June 23 amounted to almost half the Douglas shares traded during that period, and that plaintiffs purchased their shares on June 23 and June 24. The court continued:

> "Beginning about June 22 or 23, the market price of Douglas common on the NYSE took a sudden and substantial drop. **This coincided with and, according to the complaint, was caused by the substantial sales by the selling defendants on the basis of material inside information,** the disclosure of which after plaintiffs' purchases precipitated a further severe drop in the market price of Douglas common." (Emphasis added.)
>
> 495 F.2d at 233

The clear implication of this allegation was that the plaintiffs were influenced to purchase by the low price of Douglas common caused by defendants' massive sales on inside information. The price of Douglas common declined from an opening price of 90½ on June 22 to an apparent bargain closing price of 78¾ on June 23, the day of plaintiffs' first purchases. 495 F.2d 233, n. 8. Public disclosure did not occur until June 24.

E. Illegal tipping and selling, as in *Shapiro* v. *Merrill Lynch*, have different consequences from illegal purchases.

The defendants in the instant case made their purchases six weeks prior to plaintiffs' sales. Where one **sells** in an anonymous market on inside information of a kind which will probably depress the market price of the stock when it is publicly announced, the potential loss is passed on and will be realized by the person who owns the stock at the time of the public announcement. This owner may have bought from the original seller or from some intermediate purchaser. The "lighted squib" case, *Scot* v. *Shepherd*, 2 Wm.Bl. 982, 96 Eng.

Rep. 525 (1773), found in tort case-books, is analogous. The "class" of plaintiffs may be an extensive one, not limited to persons who bought during the same period of the illegal sales. Contrariwise, when one **buys** on inside information of a kind which will probably enhance the market price of the stock when released to the public, no one can be injured except a simultaneous seller.

Shapiro v. *Merrill Lynch* was a case of illegal tipping and selling. The *Texas Gulf Sulphur* litigation involved illegal purchases, but the only persons held by any Circuit Court of Appeals to be entitled to recover [5] were persons who relied on a **misleading** press release. The instant case was one of allegedly illegal purchases, but no tipping (which distinguishes it from *Shapiro* v. *Merrill Lynch*) and no misleading press release (which distinguishes it from *Mitchell* v. *Texas Gulf Sulphur*).

F. Different sources of nonpublic information.

In *Shapiro* v. *Merrill Lynch*, the information about the poor earnings of McDonnell Douglas Aircraft Company came from that company and it was that company's stock which was traded. In the instant case, on the other hand, the information that USLIFE proposed to make a merger offer to Old Line came not from Old Line but from USLIFE itself, and hence was not true "inside information." See Tentative Draft No. 2, Federal Securities Code, Section 1303, Comment 10 (American Law Institute) where the following illustration is given:

> "...A was told by Z (not an insider of X Co.) that Z's family company was about to offer a huge supply contract to X Co."

The illustration concludes that "A may legally purchase X Co.'s stock."

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[5] *Mitchell* v. *Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir. 1971).

G. No finding of fact that defendants were motivated by nonpublic information.

While both the District Court and the Court of Appeals in the instant case seemed to have assumed that the defendants, in their purchasing of Old Line stock, were motivated by the information received from USLIFE, there was no finding of fact to that effect and the undisputed and unimpeached evidence was to the contrary. Immediately prior to the purchase, the research department of J.C. Bradford & Co. had issued a "buy" recommendation on Old Line stock and both Bradfords testified that their purchases were made on the merits of the stock and not on the information from USLIFE. See Stipulation 19 at page 29 of Appendix in Court of Appeals. The assumption of the District Court apparently was that persons who have intended to buy a stock become legally inhibited from so doing if material nonpublic information is thrust upon them before the purchases are made. This question was not addressed by the Court of Appeals in the instant case, but see *Ernst & Ernst* v. *Hochfelder*, 46 L.Ed. 2d 688 (1976), holding that Rule 10b-5 imposes no liability in the absence of an intent to deceive, manipulate, or defraud. It is significant that two of the plaintiffs bought their Old Line stock after defendants' purchases, on the recommendations of their broker, Mr. Schoen, who had only the same information as J.C. Bradford & Co.'s research department. (App. page 7b; see also testimony of Schoen at page 110 of Appendix in Court of Appeals.)

H. Jurisdiction.

Finally, neither the District Court nor the Circuit Court of Appeals in the instant case, nor the District Court nor the Court of Appeals in *Shapiro* v. *Merrill-Lynch*, considered the question of jurisdiction. While jurisdiction over the 10b-6 cause of action asserted against J.C. Bradford & Co., a broker-dealer registered under §15(a) of the Exchange Act, might exist under §15(b)(3) of that Act, 15 U.S.C. §78o(b)(3), such section would not provide a jurisdictional basis against the other

defendants. If the gravamen of the tort was the **failure** to make a public announcement of material information, such **failure** could not possibly be accomplished by "use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange" (15 U.S.C., §78j). "Use" is a positive, not a negative, concept, and there can be no **use** of the mails or of facilities of any kind in **failing** to make a public announcement.

Indeed, in the instant case, there was no evidence and no finding of any "use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange," even in the purchases of Old Line stock by the defendants. Obviously there was no occasion for any such "use" in the purchases by defendant from J.C. Bradford & Co., which presumably took place at one place of business by word of mouth and by paper work within that place of business. The question of such "use" in connection with purchases or sales would appear to be irrelevant, however, where the liability is predicated only upon failure to make a public announcement for the benefit of unknown persons. In *Shapiro* v. *Merrill-Lynch*, where the decision was on the pleadings, the jurisdictional allegations were apparently not challenged. In the instant case, the Court of Appeals pretermitted the jurisdictional issue, although defendants had denied the jurisdictional allegations of the complaint, and had raised the question on the appeal.

II. THIS COURT'S DECISION IN THE *AFFILIATED UTE CITIZENS* CASE WAS NOT MISINTERPRETED BY THE SIXTH CIRCUIT.

While it is urged in the petition that the Sixth Circuit's opinion rejected the causation test announced in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972), this Court specifically limited that standard to "the circumstances of [this] case," which involved "a 'course of business' or 'a device,

scheme, or artifice' that operated as a fraud upon the Indian sellers" in face to face transactions. (406 U.S. at 153.) Moreover, this Court's recent decision in *TSC Industries, Inc.* v. *Northway, Inc.*, 48 L. Ed. 2d 757 (1976) did not reaffirm the *Affiliated Ute* test in the exchange offer context, as argued in the Petition. Rather, it reaffirmed the causation test of *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 431 (1964), under which violation and injury from a material misstatement or omission in a proxy statement was established if " **'the proxy solicitation itself...was an essential link** in the accomplishment of the transaction' " 48 L. Ed. 2d at 763. If this rule is extrapolated to the Rule 10b-5 context, it is clear that there must be some essential link between an insider's purchases and another's sales (as there was in *Affiliated Ute*) in order for liability to exist. In the instant case, there is no such "essential link" and there could be none in view of the six weeks interval between defendants' purchases and plaintiffs' sales.

III. THIS CASE NOT A PROPER VEHICLE FOR FURTHER REVIEW OF RULE 10b-5.

The decision of the District Court in the instant case can be regarded only as what would in biology be called a "sport." The reversal by the Court of Appeals leaves it, we hope, without prospect of progeny. While we are sympathetic with the notion that this Court should finally put a stop to the cancerous growth of the private right of action under Rule 10b-5, we suggest that a more appropriate vehicle for so doing might well be awaited than the instant case, in which there were so many grounds for a dismissal of the complaint.

IV. THIS CASE NOT IN CONFLICT WITH THE SECOND CIRCUIT'S DECISIONS IN *CHRIS-CRAFT* v. *PIPER AIRCRAFT CORPORATION*, 426 F.2d 569 (1970), 480 F.2d, 341 (1973), 516 F.2d, 172 (1975), *CERT. GRANTED* APRIL 6, 1976 (NOS. 75-353, 75-354, 75-355).

The Court of Appeals held, with reference to the alleged violation of Rule 10b-6, that there was no evidence of market manipulation (Footnote 15, App. page 11b-12b) and no evidence that defendants' trades "caused any change in the pricing of Old Line stock or in any way influenced plaintiffs' 'decisions to sell' " (App. page 30b). *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.* is not in conflict.

V. SCHOLARLY OPINION SUPPORTS THE DECISION BELOW.

There is an abundance of scholarly authority in complete accord with the opinion of the Court of Appeals. See, e.g., Painter, *Federal Regulation of Insider Trading* (The Mitchie Company, 1968) at 149; Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code*, 72 Mich. L. Rev. 1398, 1492 (1974). Tentative Draft No. 2 of the American Law Institute's *Federal Securities Code* (1973) supports the result reached by the Court of Appeals, rather than that reached by the District Court. As pointed out above, Section 1303, Comment 10, would permit defendants to trade on the information involved here. Section 1402(f)(2)(B) would limit defendants' liability "to the extent of the securities that defendants bought or sold," and defendants have already disgorged the maximum permissible damages under that section.

Although the Petition cites Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 Harv. L. Rev. 584 (1975) as scholarly authority opposed to the opinion below, that Note does not argue in favor of applying the *Affiliated Ute* causation standard in open market situations except when fraudulent acts have actually had an effect on the securities market.

CONCLUSION

For the reasons stated, the Petition for Certiorari should be denied.

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